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Before the
Committee on Financial Services
Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets

United States House of Representatives

Hearing on

“Examining Corporate Priorities: The Impact of Stock Buybacks on Workers, Communities, and Investment”

October 17, 2109

Chairwoman Maloney, Ranking Member Huizenga, and members of the Subcommittee: I thank you for inviting me to testify. Stock buybacks are an important and increasingly controversial feature of our capital markets. I am honored to have been asked to participate in this hearing.

I was asked for comment on the role of buybacks in the economy and their regulation, including: (1) whether the cash distributed via buybacks could instead be better used for other purposes, such as investing more in R&D; (2) the appropriate level of transparency surrounding buybacks; and (3) executives' conflicts of interest in buybacks related to their stock-based compensation.

I was also asked for comment on the following pieces of legislation: (1) H.R. ____, Stock Buyback Reform and Worker Dividend Act of 2019; (2) H.R. ____: Stock Buyback Disclosure Improvement Act of 2019; (3) H.R. 3355, Reward Work Act; and (4) H.R. ____, To amend the Securities Exchange Act of 1934 to require issuers to disclose to the Securities and Exchange Commission the details of any repurchase plan for an equity security, and to prohibit such a repurchase unless it is approved by the Commission (hereinafter, "SEC Approval Act").

In this statement, I share my background and credentials and then, in five Parts, offer my views on buybacks and my general reactions on the provisions in these pieces of legislation, some of which currently are in discussion-draft form.

Part I describes the role of stock buybacks in the economy and offers some "investor-benign" explanations for firms' use of repurchases rather than dividends to distribute cash to investors. Part I then explains that the overall level of shareholder payouts (that is, the total amount of dividends and repurchases) does not appear to be too high; in fact, it may well be too low.

Part II describes the current regulation of buybacks, which I believe is too lax and enables their abuse by corporate executives. In particular, I will explain how current regulation can enable executives to use buybacks to enrich themselves at the expense of public investors, through (1) indirect insider trading, (2) the manipulation of the stock price and EPS metrics in compensation arrangements, and (3) "false signaling:" announcing repurchases that executives do not intend to carry out, solely to boost the stock price before executives unload shares.

Part III suggests a disclosure rule that would reduce executives' ability to engage in the above-mentioned abuses, and therefore, better protect public investors: requiring public firms (like their insiders) to disclose trades in firm stock within two business days. I also describe additional measures that could be taken if this disclosure rule turns out be insufficient.

Part IV offers my initial reactions to key provisions in these four pieces of legislation. Part V concludes.

Background and Credentials

I am the Dane Professor of Law at Harvard Law School, where I teach courses on corporate law, corporate governance, securities regulation, executive compensation, and venture capital and private equity. Before joining the Harvard faculty in 2009, I was a Professor of Law and Faculty Co-Director of the Berkeley Center for Law, Business and the Economy (BCLBE) at the University of California, Berkeley. I have also been a visiting professor at Columbia University Law School, Hebrew University, IDC Herzilya, and Tel Aviv University. I hold an A.B. and A.M in Economics from Harvard University, and a J.D. *magna cum laude* from Harvard Law School.

I have authored over 40 academic articles on executive compensation, insider trading, corporate payout policy, corporate governance, and venture capital. My work has been published in the Harvard Law Review, Yale Law Journal, Harvard Business Review, Journal of Economic Perspectives, Journal of Financial Economics, and Journal of Corporate Finance. One of my main areas of research is executive compensation and insider trading. My book *Pay without Performance: the Unfulfilled Promise of Executive Compensation*, co-authored with Professor Lucian Bebchuk, has been translated into Arabic, Chinese, Japanese, and Italian. Another main area of research is share buybacks and capital flows in public companies.

I. Role of Buybacks in US Economy

A. Shareholders Payouts by Public Firms

Publicly traded U.S. firms annually generate hundreds of billions of dollars in earnings.[1] Each year, managers must decide how much of their firms' retained earnings should be distributed to shareholders through either repurchases or dividends, rather than remain in the firm for investment or other purposes. From shareholders' perspective, cash should be returned when the funds would generate more value for shareholders outside the firm than inside the firm.

In recent years, U.S. public firms have distributed around $1 trillion annually to their own shareholders through dividends and repurchases.[2] However, dividends and repurchases do not capture actual capital flows between shareholders. Firms issue large amounts of equity each year to shareholders, which moves cash from shareholders back to firms, either directly or indirectly.[3] Actual capital flows between shareholders and firms are measured by *net* shareholder payouts: dividends plus repurchases, less equity issuances.

[1] See Jesse M. Fried and Charles C.Y. Wang, Short-Termism and Capital Flows, 8 Rev. Corp. Fin. Stud. 207, 223 (2019) (hereinafter, "Fried and Wang, Short-Termism").
[2] Id.
[3] Id., at 212-222.

In 2018, U.S. public firms distributed about $1.4 trillion in dividends and repurchases to shareholders. But they also issued $750 billion of equity, directly or indirectly, to public shareholders. Net shareholder payouts—the cash shareholders were left with at the end of the year were therefore about $650 billion.

Net shareholder payouts from public firms become available for investment in private firms, which are typically younger and faster growing and absorb hundreds of billions of dollars per year in funding.[4] These private firms are vital to the U.S. economy and just as important as public firms. Such firms account for more than 50% of nonresidential fixed investment, employ almost 70% of U.S. workers, and generate nearly half of business profit.[5] Indeed, much of the critical innovation in our economy—including breakthroughs in pharmaceuticals and information technology—takes place in small, private firms.

In sum, shareholder payouts can benefit shareholders by enabling them to generate more value for themselves than if the cash is left in the firm. And shareholder payouts by public firms can thus benefit the economy as a whole by making capital available to smaller, growing firms that will engage in investment and hire American workers, the vast majority of whom work for private firms.

B. Investor-Benign Reasons for Repurchases

Managers must decide not only how much cash to distribute to shareholders but also the manner in which the cash should be paid out—through dividends, share repurchases, or both. During the 1980s and 1990s, many firms began using open market repurchases[6] to distribute cash, in addition to dividends or in place of dividends.[7] Currently, about 40% of distributions take the form of dividends and 60% take the form of repurchases.[8]

There are a number of reasons why it may be in shareholders' interest for managers to use a repurchase rather than a dividend.[9] The two most important are (1) tax savings and (2) the firm's ability to use a buyback to acquire shares to incentivize employees to generate shareholder value.

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[4] See Fried and Wang, Short-Termism, at 229.
[5] Id.
[6] Share repurchases can take the form of either an open market repurchase (OMR) or a repurchase tender offer (RTO). In an OMR, the firm buys its own stock on the market through a broker. In an RTO, the firm offers to buy back its own stock directly from shareholders, usually at a premium over the market price. See generally Jesse M. Fried, Insider Signaling and Insider Trading with Repurchase Tender Offers, 67 U. Chic. L. Rev., 421 (2000). OMRs are by far the most important. See generally Jesse M. Fried, Informed Trading and False Signaling with Open Market Repurchases, 93 Cal. L. Rev. 1323 (2005)(hereinafter, "Fried, Informed Trading"). My remarks here will focus on OMRs and throughout I will use the term "repurchases" to refer to OMRs.
[7] Fried, Informed Trading, at 1335.
[8] Fried and Wang, Short-Termism, at 212.
[9] Fried, Informed Trading, at 1336-1340.

Tax Efficiency. For U.S. taxable shareholders, repurchases tend to be a more tax-efficient means of receiving cash than dividends.[10] First, repurchases tend to shift the tax burden to shareholders with lower marginal rates. When a firm issues a dividend, all taxable shareholders are taxed on their pro rata share of the dividend. In contrast, when the firm repurchases shares, only those shareholders who choose to sell their shares are taxed. To the extent higher-bracket shareholders avoid selling their shares, leaving the selling to lower-bracket (or tax-exempt) shareholders, the aggregate tax burden on shareholders is reduced.

Second, repurchases allow tax-free recovery of "basis." A shareholder receiving a dividend is taxed on the entire amount. By contrast, a selling shareholder is not taxed on the full amount of the sale proceeds but only on the capital gains (the difference between the sale proceeds and the shareholder's cost basis in the stock). The tax-free recovery of basis, together with the bracket-shifting effect described earlier, can make repurchases more tax-efficient than dividends, even when the tax rates on dividend income and capital gains are the same.[11]

Employee Equity-Compensation Plans. A repurchase enables a firm to acquire shares for executive and employee equity-based pay programs, an important form of compensation in many firms designed to align executives' and employees' interests with those of shareholders.[12] Market-wide, over 50% of issued shares are given to employees; of these shares, 15% go to top-5 executives and 85% go to lower-ranking employees.[13] Issued shares total about 80% of repurchased shares.[14] Thus, market-wide, about 40% of repurchased shares are used for compensation.

It is important to understand how value moves when a firm repurchases a share and later issues the share to an employee, who then sells the share to public investors. The net effect is the same as a transaction in which the firm pays the employee cash, reducing the assets of the firm and the value of each shareholders' interest in it.[15] For example: the repurchase of a share for (say) $100 and the issuance of that share to an employee who sells the share for (say) $100 has the following effects: it puts $100 in the pocket of the employee and leaves shareholders owning a corporation that has $100 less in assets. In other words, it represents a movement of value from shareholders to employees of $100.

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[10] Fried, Informed Trading, at 1336-38.

[11] U.S. nontaxable shareholders (such as pension funds) would be indifferent to the form of cash distribution. Foreign shareholders would generally prefer repurchases because of differences in withholding. See https://www.taxpolicycenter.org/taxvox/tackling-stock-buybacks-too-little-too-late-foreign-investors

[12] Fried, Informed Trading, at 1339.

[13] Fried and Wang, Short-Termism, at 214-16.

[14] Id., at 219.

[15] Id., at 214-216.

C. Assessing the Overall Volume of Shareholder Payouts

Critics of buybacks often compare the magnitude of shareholder payouts (dividends and repurchases) to net income, and conclude that public firms are depriving themselves of the resources necessary to grow. However, there are two problems in comparing shareholder payouts to net income.

First, as explained above, shareholder payouts are an incorrect measure of shareholder-firm capital flows because they exclude effects of equity issuances. Across the market, equity issuances total about 80% of repurchases and about 50% of shareholder payouts.[16] Market-wide, for every $100 of repurchases, firms issue $80 of equity; public investors thus net $20.

Second, net income is a poor measure of income available for investment: it assumes that the expenses deducted to arrive at net income are entirely unrelated to future-oriented investment. In fact, net income is computed after deducting the substantial expenses associated with R&D, which is by definition future oriented. From 2007 to 2016, for example, total R&D expenditures for S&P 500 companies equaled about 28% of total net income.[17] Therefore, net income at best measures the amount available for capital expenditures (CAPEX) and *additional* R&D.

A better measure of income available for investment is "R&D-adjusted net income," which adds a firm's R&D expenses (net of its effective tax rate) back to its net income. Net shareholder payouts as a percentage of R&D-adjusted net income appear quite low. From 2007 to 2016, net shareholder payouts by all public firms amounted to only 33% of R&D-adjusted net income. Even after net shareholder payouts these firms would have had $6.6 trillion available for CAPEX, R&D, and other investment by the end of 2016, even had they started the period with cash balances of zero.[18] (The results are similar after updating to include 2017 and 2018.)

In fact, during 2007-2016 overall investment climbed, reaching record levels in absolute terms and very high levels relative to revenues (so-called "investment intensity"). While overall investment intensity by public firms is volatile on a year-to-year basis, it increased during the decade 2007-2016, and ended the period near levels not seen since the late 1990s boom. By the end of this period, R&D intensity was at a historical high.[19] (Through 2018, overall investment and R&D have continued to increase, both in absolute terms and relative to revenues.)

Nor did a scarcity of cash constrain investment levels, preventing them from being even higher. Corporate cash stockpiles were huge and grew during the 2007-2016 decade. In 2007,

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[16] Fried and Wang, Short-Termism, at 219.
[17] Id., at 223-25.
[18] Id.
[19] Id., at 227.

public firms held $3.3 trillion in cash. By 2016, this amount had grown by nearly 50%, to $4.9 trillion.[20] These amounts continued to grow in 2017-2018, although there was a slight decline in 2018 relative to 2017. There is good reason to believe that much of this $5 trillion in idle cash sitting in public firms could be better invested in other firms.

Even if a particular firm's net shareholder payouts were very high relative to R&D-adjusted net income, that firm would not necessarily lack the capacity to invest and innovate, as it can simply issue more stock to public investors. The amount of equity issued by any given public firm in any given year does not represent a cap; the firm could generally have issued even more stock to raise cash, acquire assets, or pay employees.[21] Thus, if that firm has a valuable investment opportunity, but little cash, the firm can use equity financing to take advantage of the opportunity. Indeed, small, more quickly-growing public firms outside the S&P 500 issued more equity each year during the period 2007-2016 than they paid out in dividends and repurchases.[22]

II. Current Regulation and Executives' Abuse of Buybacks

A. Current Regulation

For our purposes, the three most important components of buyback regulation are: (1) disclosure requirements (both upon announcement of a buyback plan and after repurchases have commenced; (2) Rule 10b-5's prohibition against repurchasing shares on material nonpublic information; and (3) anti-manipulation rules.

Disclosure Requirements. Before it can begin buying back shares on the open market, a firm traded on NASDAQ or another stock exchange is required to announce its board's decision to approve an open-market buyback program.[23] But such an announcement need not provide specific details about the program. A firm is not required to indicate the number or dollar amount of shares to be repurchased. Nor must the firm indicate the expiration date of its buyback program. Even if a firm voluntarily indicates a repurchase target, it will typically state that actual repurchases will depend on market conditions. As a result, firms do not commit -- and are not obligated-- to buy back any stock. In fact, one study found that almost 30% of firms announcing repurchases do not buy back a single share during the fiscal year in which the repurchase announcement occurs, with about 15% not buying back any shares within four fiscal years of the announcement year.

[20] Id., at 226-227.
[21] Id., at 228-229.
[22] Id. at 221-222.
[23] For all sources for this paragraph, see Jesse M. Fried, Insider Trading via the Corporation, 162 U. Penn. L. Rev. 801, 813 (2014) (hereinafter, "Fried, Insider Trading").

After a firm repurchases shares, it must provide very limited disclosure. Before 2003, a firm did not have to disclose <u>any</u> information regarding repurchases.[24] Since 2003, however, the SEC has required a repurchasing firm to report, in its quarterly Form 10-Q (or Form 10-K) filing with the SEC, the number of shares repurchased in each month of that quarter and the average price paid for each share. Because such filings can be made a month or so after the end of the quarter, investors cannot be expected to learn about share repurchases in the prior quarter until one to four months after they occur. By contrast, insiders of publicly-traded firms trading in their own firms' shares must disclose the details of each trade within two business days under Section 16(a) of the Securities Exchange Act of 1934.

Rule 10b-5. Rule 10b-5 requires persons owing a pre-existing fiduciary duty to the firm's shareholders, including corporate insiders, to disclose any material nonpublic information or abstain from trading in the firm's shares. The SEC takes the position that Rule 10b-5 also applies to a firm buying its own shares, even though a corporation is not considered to owe a fiduciary duty to its own shareholders.[25]

However, there are two limits to 10b-5's ability to prevent the firm from trading on all types of valuable inside information. First, the courts' high materiality threshold permits the firm to trade legally on many types of important but "sub-material" information.[26] Second, a prohibition against trading on "material" nonpublic information may not always deter such trading because of detection and enforcement problems.[27] Detecting a violation of Rule 10b-5 by a firm's insiders is difficult even though they must report individual trades under Section 16(a).[28] Because current trade-disclosure rules for the firm do not require a firm to report individual trades, but rather only monthly averages, it is even more difficult to detect a violation of Rule 10b-5 by a firm that repurchases its own shares while in possession of material inside information.

Anti-Manipulation Rules and the Rule 10b-18 Safe Harbor. Corporations, like individuals, are subject to the anti-manipulation provisions of Section 9(a)(2) of the Securities Exchange Act of 1934.[29] These provisions make it illegal to conduct a series of transactions creating actual or apparent active trading in a security to induce others to buy or sell the security. Purchases of a firm's own shares could be considered manipulative if the intent of the repurchase is to drive up the stock price by making it appear that there is unusually heavy demand for the stock.

In 1982, the SEC adopted Rule 10b-18, which provides repurchasing firms a "safe harbor" from anti-manipulation liability when they repurchase their shares in accordance with

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[24] For all sources for this paragraph, see Fried, Insider Trading, at 814-815.
[25] Id., at 813-814.
[26] Id., at 808-809.
[27] Id.
[28] Id.at 813-814.
[29] Fried, Informed Trading, at 1341-42, for all sources in this and the following paragraph.

the rule's "manner, timing, price, and volume" conditions. The rule went into effect in 1983 and appears to have made managers more willing to engage in open market repurchases: the volume of repurchases increased sharply shortly after the rule became effective. But not all firms comply with these conditions. This is not surprising. It is not clear how the anti-manipulation provisions can be effectively enforced when regulators cannot easily observe the individual trades made by a firm in its own shares.

B. Executives' Abuse of Buybacks

Executives can use buybacks to transfer value from public investors to themselves, reducing investor returns and, perhaps, distorting corporate decision-making in a way that reduces the size of the overall economic pie.[30] This abuse is facilitated by the lax disclosure rules applicable to buybacks.

Indirect Insider Trading. Executives will have an incentive to conduct a buyback when they believe that the stock price is less than the stock's actual value (a "bargain repurchase"). A bargain repurchase transfers value from selling shareholders to non-selling shareholders pro rata.[31] Thus, to the extent insiders own shares in the firm and decline to sell their shares at a cheap price (which they can be expected to do), they will benefit from a bargain repurchase. Insiders of U.S. firms announcing repurchases tend to own a substantial fraction of the firms' shares before the repurchase -- an average of 15-20% -- which is roughly the same as the average insider ownership across all firms. Thus, when insiders know that stock prices are low, they have a strong incentive to conduct a bargain repurchase to transfer value from selling shareholders to themselves and other non-selling shareholders. There is substantial evidence of bargain repurchases, and I have estimated that insiders divert about $5 billion annually through them, at the expense of public investors.[32]

This indirect insider trading is facilitated by the current disclosure rules, which make it difficult to enforce Rule 10b-5 against the firm and which fail to provide public investors with real-time disclosure about the firm's repurchase activity. For example, if investors knew that the firm was aggressively buying shares, they might infer that the stock is underpriced and reassess their valuations of the firm, causing the price to rise and making it harder for insiders to conduct a bargain repurchase.

EPS and Stock-Price Manipulation. There is evidence consistent with executives engaging in buybacks to boost EPS when they are in danger of falling short of forecasted EPS,[33] although it is unclear whether public investors are harmed. Executives might also conduct

[30] See generally Fried, Informed Trading and Fried, Insider Trading.
[31] See Fried, Insider Trading, at 815-820, for all sources relevant to this paragraph.
[32] Fried, Informed Trading, at 1357-1360.
[33] Heitor Almeida, Vyacheslav Fos, and Mathias Kronlund, The Real Effects of Share Repurchases, J. Fin. Econ. (2016).

repurchases to exert upward price pressure on the stock while selling their shares,[34] which would systematically transfer value from public investors to themselves. Depending on how executives' EPS-based bonuses are structured, executives might have an incentive to buy back shares simply to trigger a bonus, which again enriches them at public investors' expense. The lack of detailed, timely disclosure of repurchases emboldens insiders to engage in these strategies by making the abuse difficult to detect.

False Signaling with Misleading Repurchase Announcements. Managers wishing to sell their own shares at a higher price may have an incentive to announce a share repurchase they do not intend to conduct simply to boost the stock price.[35] A repurchase program announcement is generally greeted favorably by the market, as it can signal the stock is undervalued or that excess cash will finally be distributed (rather than being wasted or left to languish inside the firm). By announcing a repurchase program even when they have no intention of repurchasing stock, managers about to sell their own shares essentially attempt to "mimic" managers of firms that use repurchases to buy stock at a low price (or simply to distribute cash). This mimicking appears to be successful: there is no difference in market reaction between announcements followed by repurchase activity and announcements not followed by actual buybacks. To the extent that managers use misleading repurchase announcements to sell their shares for more than their actual value, they transfer value from the parties buying their shares.

III. Two-Day Disclosure Rule

A. The Proposal

Section 16(a) of the Securities Exchange Act of 1934 currently requires corporate insiders to provide detailed information about any trade in their firm's shares within two business days. Firms trading in their own shares, by contrast, may wait months until they disclose the existence of trading activity in their own shares, and can get away with providing only aggregate data.

These lax trade-reporting rules make it easier for insiders to trade indirectly on inside information, imposing potentially large costs on public shareholders. And the easier it is for insiders to engage in bargain repurchases, the greater will be the stock price reaction to a buyback-plan announcement, which in turn makes false signaling more profitable for insiders. Finally, lax disclosure rules make it harder for regulators to detect the use of repurchases to boost the stock price before executive stock-unloading or to improperly achieve EPS hurdles in compensation arrangements.

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[34] See generally Lenore M. Palladino, Do Corporate Insiders use Stock Buybacks for Personal Gain? (Roosevelt Institute Working Paper, 2019).
[35] See Fried, Informed Trading, at 1352-56, which contains sources for the entire paragraph.

These costs would be reduced if a firm were subject to the same trade-disclosure requirements as its insiders. In particular, a corporation should be required to disclose each trade in its own shares within two business days of the transaction. [36] This two-day rule would improve transparency and provide public investors with a timely, accurate, and comprehensive picture of insiders' trading, both direct and indirect via the firm.

The proposed two-day rule would not unduly burden firms, just as Section 16(a) has not unduly burdened insiders. Indeed, the largest stock markets outside the United States already require even more timely disclosure by firms of trades in their own shares. For example, in the United Kingdom and Hong Kong, publicly traded firms must report all share repurchases to the stock exchange before trading begins the next business day. Japan requires same–day disclosure. If firms in Hong Kong, Japan, and the United Kingdom can disclose open–market transactions by the end of the trading day (or by the next morning), U.S. firms should be able to disclose their trades within two days without too much difficulty.

B. A Step in the Right Direction

A two-day disclosure rule would be a substantial improvement over existing disclosure requirements but might not go far enough. The two–day rule would still enable insiders to engage in some indirect insider trading, just as Section 16(a) permits insiders to engage in some direct insider trading.[37] Most importantly, to the extent the market does not immediately adjust to the information communicated by a trade disclosure, but rather does so only over time, a firm can continue to trade profitably on inside information even after the market begins adjusting to the information provided by its trade disclosures.

Because of the limitations of a two–day rule, a one–day or same-day rule for both firms <u>and</u> insiders would be even better. Insiders would have less time to trade secretly, directly or indirectly. And stock prices would have more time to impound the information signaled by trade disclosures, reducing insider-trading profits on subsequent trades.

Indeed, I have elsewhere proposed that both insiders and firms be required to disclose their planned trades in advance.[38] Such a pre-trading disclosure rule, I have shown, would substantially reduce the costs associated with direct and indirect insider trading.[39] Thus, I do not claim that the two–day rule proposed here is ideal. Rather, I see the adoption of such a rule as an easy (but important) step in the right direction—-a measure that would harmonize insider-trading rules, improve transparency in the capital markets, and substantially reduce

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[36] The rule should also apply to at-the-market (ATM) equity issuances.

[37] See Fried, Insider Trading, at 838.

[38] See Fried, Informed Trading, at 1375-76; Fried, Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure, 71 S. Cal. L. Rev. 303, 329-48 (1998)(hereinafter, "Fried, Reducing the Profitability").

[39] See Fried, Informed Trading at 1376–82; Fried, Reducing the Profitability, 353–64.

indirect insider trading and its costs. But should the detailed disclosure provided by the two-day rule indicate that abuses were continuing, more aggressive steps—such as requiring pre-trading disclosure—could be considered.

IV. Comments on Bills

I now turn to comment on the provisions of the four buyback-related bills. I will not focus on the technical details of each bill, as there is considerable overlap among them and some of these bills are in draft form. Instead, I will speak to the general desirability of the various types of regulatory approaches embodied in these bills, explaining why I think some of them do not go far enough while others go too far.

A. Improved Disclosure Around Initiation of Repurchases

The Stock Buyback Reform and Worker Dividend Act of 2019, The Stock Buyback Disclosure Improvement Act of 2019, and the SEC Approval Act all require firms to make certain disclosures before commencing a stock buyback. Depending on the bill, these disclosures can include the rationale for the repurchase, whether any executive is purchasing or is permitted to sell stock during the pendency of the repurchase, and the source of funds for the repurchase.

I am skeptical that such disclosures will, by themselves, materially affect the ability of corporate executives to use repurchases for indirect insider trading, to boost the short-term stock price, or manipulate EPS metrics in compensation arrangements. However, it is possible such disclosure could have a beneficial "naming and shaming" effect or could cause a firm's board to better focus on certain aspects of their repurchase and compensation programs. The only certainty is that requiring firms to provide additional disclosures imposes transaction and additional legal costs on firms which, everything else equal, will reduce investor returns.

B. Prohibition on Certain Sales by Executives around Repurchase Announcements

The Stock Buyback Reform and Worker Dividend Act of 2019 prohibits executives from selling shares for 7 days after the announcement of the initiation, continuation, or increase in size of a repurchase program, with certain exceptions.

I am skeptical that this requirement will have much effect on executives, because the stock-price increase following a repurchase announcement, whether or not the announcement represents false signaling, is likely to endure beyond 7 days.

C. Improved Post-Repurchase Disclosure

The Stock Buyback Reform and Worker Dividend Act of 2019 requires each firm repurchasing its own stock to disclose, during the last business day of each week, the number of shares purchased in the previous week (if not zero) and the average price per share.

This disclosure requirement is a substantial improvement over the current requirement that firms need only disclose transactions on a monthly basis several months after-the-fact. The requirement would reduce executives' ability to engage in indirect insider trading by alerting the market more quickly as to information-driven trading so it could respond, as well as by making it easier to detect violations of Rule 10b-5. The requirement would also make it easier to spot repurchases designed to help executives sell their shares at a higher price or trigger EPS-based bonuses.

However, the requirement would not be as effective as the two-day disclosure rule I put forward, because (1) it could take 9 more days for trading to be revealed and (2) the trade information be less granular, making it more difficult for investors and regulators to identify particular days on which problematic trading occurred.

The SEC Approval Act would require a repurchasing firm to disclose to the SEC, after the end of each calendar month, the "full details" of that month's repurchases, including the date, quantity, and price paid. The SEC Approval Act appears to contemplate the same type of granular disclosure as the two-day disclosure rule I put forward, which will make it easier to detect (1) violations of Rule 10b-5 and anti-manipulation rules and (2) attempts by executives to boost their bonus pay or the stock price. But the month lag time will make it more difficult for market participants to adjust valuations of the firm in light of recent repurchase activity, making it easier for insiders to trade indirectly on valuable information.

D. Elimination of the Rule 10b-18 Safe Harbor and Restrictions on Manner of Repurchases

The Stock Buyback Reform and Worker Dividend Act of 2019 eliminates the Rule 10b-18 safe harbor and imposes restrictions on the manner of repurchase. This may well provide a modest benefit in preventing use of repurchases to boost the short-term stock price.

Eliminating the Rule 10b-18 safe harbor, by itself, would likely have little effect unless firms came to believe that they were at greater risk for exposure to manipulation liability. To my knowledge, the SEC has not shown much interest in determining whether firms use repurchases to manipulate the stock price. And should that change, the disclosure requirements imposed by the Stock Buyback Reform and Worker Dividend Act of 2019 might not be sufficient to detect manipulative activity. The two-day disclosure rule I put forward, requiring detailed reporting of individual trades, would be more helpful.

E. SEC Approval Requirement for Repurchases

The SEC Approval Act gives the SEC the power to block a repurchase, after reviewing certain disclosures by the firm about the possible effects of the repurchase. As I indicated above, I don't believe that such disclosures by themselves are likely to make much difference in how repurchases are executed. And I am skeptical that the SEC would block any repurchases. If

I am correct, this SEC approval requirement would just drive up transaction costs, at investors' expense (and at the expense of the SEC's attention to other, more pressing, issues). If I am wrong, this requirement will tilt firms to dividends or slightly reduce the volume of repurchases, with the effect on investors unclear.

F. Outright Ban on Open-Market Repurchases

The Reward Work Act would ban open-market repurchases. Such a ban would likely be extremely disruptive to firms and very harmful to shareholders, as it would throw a monkey wrench into firms' equity-compensation arrangements, which have been built on the assumption that firms can continue to repurchase shares to give to executives and lower-level employees.[40]

There is no reason to do something so drastic before first adopting a two-day disclosure rule, which would likely reduce most of the abuses associated with repurchases. The two-day rule would also provide shareholders and regulators more information about how repurchases are executed, and enable a determination as to whether more aggressive regulation is required.

G. Beyond Repurchases

Two bills feature provisions that go beyond the regulation of repurchases. The Reward Work Act requires that at least 1/3 of an issuer's directors be employees (presumably in addition to the CEO and other high-level officers serving on the board). The Stock Buyback Reform and Worker Dividend Act of 2019 forces firms to pay employees a "worker dividend" based on the value of shares repurchased and any increase in the amount of ordinary dividends (or the issuance of special dividends).

In my view, adoption of either type of provision would create substantial dislocations in our capital markets, undermine our economy, and provide a windfall to the finance industry.

The Reward Work Act would reduce public-firm director accountability to investors. When more than a third of a company's board consists of executives or their direct or indirect reports, investors would need to win almost every other seat to wrest control from incumbent management. As a result, boards will have little incentive to properly allocate capital, including distributing it when necessary.

The Stock Buyback Reform and Worker Dividend Act of 2019 would not affect director accountability to investors, but essentially impose a tax on the return of capital, distorting the

[40] It is possible that firms could, with sufficient advance notice, transition to using synthetic shares rather than actual stock.

flow of investment funds in the economy. And because this tax increases with the number of employees, we can expect public firms to hire fewer workers.

In either case, excess capital would flow more slowly out of firms and be mis-invested. Smaller companies would be deprived of funds, making it harder for them to innovate and hire workers.

Of course, firms do not have to remain public. They can go private. And many firms that are currently public will go private to escape this kind of intrusive regulation, which completely over-rides the bargained-for protections offered to investors providing capital to help these businesses grow. IPOs would dry up. Ordinary Americans will find it more difficult to invest in large businesses. There would also be a large payday for law firms, investment banks, corporate insiders, and private-equity firms that would profit substantially from taking these firms private. All of this would tend to increase income inequality.

V. Conclusion

The volume of share repurchases and dividends by public companies does not appear to be compromising these firms' ability to invest, innovate, or pay higher wages. Investment levels (CAPEX and R&D) are at record highs in absolute terms, and (over a 25-year time frame) either at record or near-record highs relative to revenues. Nor is investment constrained by lack of cash, as public firms are sitting on about $5 trillion of cash (even after record shareholder payouts). Individual public firms that are strapped for cash can always issue more equity to public investors, which they routinely do. Profits distributed by large, mature public firms are made available for smaller, faster-growing private firms, which employ more than two-thirds of private-sector workers.

Share repurchases can provide certain benefits to public investors. For example, they enable firms to acquire equity to grant to employees to align their interests with those of shareholders. However, executives can also use repurchases to transfer value from public investors to themselves, including through indirect insider trading. This abuse arises due to lax disclosure requirements around repurchases. Tightening disclosure requirements by requiring repurchases to be individually disclosed within two days would go far in reducing executives' abuse of repurchases, in a manner that does not interfere with the use of repurchases for benign purposes. Such detailed disclosure requirements would also enable Congress or the SEC to determine whether further steps are needed.

In my view, the provisions of the four repurchase-related bills under consideration either go too far, or do not go far enough, relative to the 2-day disclosure rule.

Thank you again for the opportunity to discuss this important subject, and I look forward to your questions.